



Two Harbors Investment Corp.
Second Quarter 2021 Earnings Call Transcript

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TWO HARBORS
Investment Corp.
A Pine River Capital Managed Company

PREPARED REMARKS

Operator: Greetings. Welcome to the Two Harbors Investment Corp. report Second Quarter 2021 Financial Results. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press “*”, “0” on your telephone keypad. Please note this conference is being recorded. I will now turn the conference over to your host, Paulina Sims. You may begin.

Paulina: Good morning everyone and welcome to our call to discuss Two Harbors’ second quarter 2021 financial results. With me on the call this morning are Bill Greenberg, our President, Chief Executive Officer, and Chief Investment Officer and Mary Risky, our Chief Financial Officer.

The press release and financial tables associated with today's call were filed yesterday with the SEC and are available on both the Two Harbors’ and SEC websites. In our earnings release and slides, we have provided a reconciliation of GAAP to non-GAAP financial measures. We urge you to review this information in conjunction with today’s call. I would also like to mention that this call is being webcast and may be accessed in the investor relations section of our website.

As a reminder, remarks made by management during this conference call and the supporting slides may include forward-looking statements. These statements are based on the current beliefs and expectations of management, and actual results may be materially different because of a variety of risks and other factors. We caution investors not to rely unduly on forward-looking statements. Except as may be required by law, Two Harbors does not update forward-looking statements and expressly disclaims any obligation to do so.

I will now turn the call over to Bill.

Bill: Thank you, Paulina. Good morning everyone and welcome to our second quarter earnings call.

Before we begin, I’d like to acknowledge Matt Koeppen’s departure from the company on June 30th. Matt and I worked very closely together over the last 9 years and we had a very productive partnership. On behalf of the Two Harbors team, I’d like to thank Matt for his years of service to the company, and we wish him good luck in his future endeavors. As we announced a few weeks ago, I have taken on the role of Chief Investment Officer once again and I look forward to working with the investment team, as well as the rest of the company, to navigate through the complex market environment in front of us.

Please turn to slide 3. At quarter end, book value was \$6.42 per share, representing a negative 9.6% total economic quarterly return. The second quarter performance is almost entirely the result of significantly wider spreads on high coupon RMBS. The stubborn absence of prepayment burnout, along with the introduction of government programs, to help borrowers refinance both contributed to changing market expectations around prepayment speeds in these coupons.

The MSR market was very active and we saw \$125 billion UPB in bulk deals come to market in the second quarter alone, bringing the year-to-date volumes to approximately \$180 billion, which is roughly the volume that we might typically see for a full year. We have been successful in deploying more capital in the MSR space this quarter as we purchased \$6.5 billion UPB through bulk transactions and have commitments to add another \$17 billion UPB subsequent to quarter-end. Additionally, we settled on \$16.4 billion UPB in our flow sale program during the quarter.

Core earnings were 19 cents per share. However, spread movements generally dominate the portfolio performance relative to core earnings, and this quarter was no exception. In the absence of spread movements, and with more than one quarter in mind, we believe the portfolio can support a dividend of 17 cents, which the Board declared for the second quarter.

Post-quarter-end, we issued approximately \$256 million of common equity in a riskless, non-dilutive transaction by selling shares right at our book value. Besides being accretive to EPS by virtue of the expense dilution alone, we felt that it was advantageous to both current and new shareholders to be prepared to invest in our target assets when the opportunity to do so presents itself. We expect that MSR supply will be robust in the second half, and we think that Fed tapering and reduced bank buying will lead to wider, not tighter, RMBS spreads when that finally occurs either later this year or early next. We have been disciplined in keeping our leverage low, as mortgage spreads have hovered around all-time tight levels. This positioning has not cost us anything in terms of performance thus far, and in fact has saved us from additional losses, as every coupon has underperformed their hedges for the last two quarters. As a result of our new equity and our liquidity positioning, which Mary will discuss further, we have plenty of dry powder to invest at attractive levels.

Please turn to slide 4, and I will briefly discuss the overall market environment.

The second quarter of 2021 was characterized by falling long term interest rates, a flatter yield curve and, despite continued buying of current coupon RMBS from the Federal Reserve and large money-center banks, wider mortgage spreads. Inflationary pressures have generally increased as the reopening of the economy has highlighted gaps in the supply chain and scarcity of workers, especially in restaurants, travel, and the service sectors in general.

As an indication, in mid-July the CPI index printed at 5.4% which is the highest it's been in 13 years, and is shown in Figure 1 by the blue line. Compared to two years ago, which removes the base effects from the pandemic, overall CPI prices are still up a healthy 2.5%. Interestingly, many market participants have pointed out that prices in the used car and truck sector, shown by the gray line in the figure, increased by more than 40% in the period, and was responsible for a large part of the aggregate increase in CPI. The Fed and many economists have insisted that inflation spikes such as this are temporary, although many other market participants aren't so sure.

At the June Fed meeting, the Fed surprised the market by moving forward its median expectation for its first two rate hikes to late 2023. Although the initial market reaction was for higher rates, later interpretations focused on whether the Fed, in moving its median rate hike expectations, had changed its reaction function and might choke off growth prematurely just as the economy is getting going. Some market participants have pointed to the Delta variant of the COVID virus as being a risk to forward growth, or whether future growth can keep up with the optimistic expectations that are already priced into the equity markets.

At the July meeting last week, the Fed confirmed that the labor market has shown significant improvement, but Chairman Powell indicated that multiple strong jobs reports are required before commencing the tapering process. Chairman Powell also clarified that while there is little support to start tapering RMBS before Treasuries, it could possibly reduce RMBS purchases at a faster monthly pace.

Whether for the reasons I just described, or simply because of positioning and other technical factors, ten year interest rates ended the quarter 35 basis points lower, retracing a large portion of the increase which occurred during Q1, while shorter term interest rates were largely unchanged.

Despite the fact that the Fed is now clearly "talking about tapering", spreads on current coupon RMBS were largely unchanged on the quarter, and still sit at very tight levels, with current coupon OAS at -3 basis points, as seen in Figure 3. Compared to other periods of quantitative easing in the past where the Fed was buying mortgages, these spreads are still at least 10 basis points rich to those periods, and compared to periods where the Fed was not actively buying mortgages, spreads are about 30 basis points lower. The Fed has stated that they are committed to a tapering process which is "orderly, methodical, and transparent," and we have no reason to doubt the Fed's intentions. However, the picture is further complicated by the large amount of RMBS that has been purchased by the banking sector, which has been fueled by increased deposits and low loan growth. With the news that all of the large banks considered passed their Dodd-Frank Act stress tests, it is likely that dividend increases and share buybacks may lessen bank appetite for low yielding RMBS. Indeed, we have already seen signs of decreasing demand from banks, as the recent H8 data shows that banks bought \$100 billion of RMBS in the second quarter, as

compared to about \$180 billion in the first. In addition, it appears that the second quarter was the first since 2019 where the supply of mortgages was higher than the combined demand from the banks and Fed.

Please turn to slide 5. Within the backdrop of the transitioning macro-economic environment, there has been more policy activity in the GSE market than there has been since the onset of the pandemic.

Recent leadership appointments at the FHFA and HUD along with new programs such as RefiNow and RefiPossible illustrate a shift from the previous administration towards providing continued relief for distressed, low-income, or credit-impaired borrowers, supporting affordable housing, and increasing the credit box and the footprint of the GSE's to support the administration's housing goals.

On the other side of the ledger, steps have been taken to finally remove some of the accommodation that was provided at the onset of the pandemic, such as the foreclosure moratorium and, for FHA, VA, and HUD borrowers, the ability to enter into forbearance arrangements. Deferral still remains the best option for borrowers to become current again on their loans. As an MSR owner, we are committed to working diligently with our subservicing partners to do everything we can to help keep borrowers in their homes.

I will now turn it over to Mary to walk you through a discussion of our financial results.

Mary:

Thank you, Bill and good morning everyone

Please turn to slide 6, to review our financial results for the second quarter. Comprehensive income was negative \$194.6 million, representing an annualized return on average common equity of negative 40.7%. And our book value was \$6.42 per share compared to \$7.29 at March 31st, resulting in a total economic return of negative 9.6%. As Bill mentioned earlier, the quarter over quarter decline was the result of significantly wider spreads on high coupon RMBS where we have significant exposure.

Moving on to slide 7, Core Earnings were \$0.19 per share compared to \$0.17 in Q1. Interest income decreased from \$56.1 million to \$43.4 million, as our RMBS position continued to decline through a combination of sales and paydowns. Interest expense rose by \$1.7 million reflecting the increase in financing related to the growth in our MSR portfolio as well as a full quarter of interest expense on our convertible debt issued in February. Gains on other derivative rose by \$7.7 million, as we benefited from a larger position in TBA as well as increased roll specialness.

Turning to MSR, net servicing income increased by \$3.6 million to \$47.4 million. This was a result of higher balances, slower speeds and fewer delinquencies. There was also a notable decrease in expense, the majority of which is related

to servicing expenses and driven by a number of opposing one-time items, with first quarter incurring certain non-recurring costs and second quarter including certain non-recurring credits. An average of the two quarters expense is a better indication of the run rate for the 1st half of the year.

In the table on the lower right, we show our portfolio yields. Our realized net spread in the quarter rose by 28 basis points to 1.93%, driven by a 47 basis point increase in our portfolio yield which more than offset a 19 basis point increase in funding costs. This net increase was driven primarily by improved MSR asset yields, offset by increased MSR financing which carries a higher borrowing rate. Net spread as of June 30th, which reflects our estimate for the near term, is expected to increase modestly due to a higher proportion of MSR in the portfolio and slightly higher RMBS yield.

Turning to Slide 8, our liquidity and capital positions continue to be strong. Post quarter end, we issued 40 million shares of common stock for net proceeds of approximately \$256 million – which – when combined with excess cash on hand – positions us to invest in MSR, and in RMBS when spreads widen out to more attractive levels.

Our unrestricted cash balance totaled \$1.3 billion at quarter end. Funding for Agency RMBS through the repo market remains attractive. As expected, financing for MSR through bilateral facilities has increased as we buy more MSR assets as well as diversify and optimize our financing facilities given minimum use requirements.

Finally, leverage remained relatively unchanged from the prior quarter with both the average and quarter-end economic debt-to-equity at 6.5x.

I will now turn the call back to Bill for a markets overview and portfolio update.

Bill:

Thank you Mary. Let's turn to slide 9, to discuss our quarterly portfolio activity and composition.

We have remained disciplined in our positioning ahead of anticipated RMBS tapering and reduction in bank buying. The portfolio balance decreased from \$18.6 billion to \$17.1 billion through a combination of sales and runoff. In particular, we sold some 2.5% and 3% coupon pools and bought 2.5% coupon TBA's, as we felt the pools were unattractive from a spread perspective while the roll specialness of the TBA still allowed for positive return potential. Our MSR value was down slightly, even though we added more UPB than prepaid, which simply reflects lower prices into a lower interest rate environment.

Please turn to slide 10, as we discuss our specified pool positioning, prepayments, and performance. As you can see in Figure 1, we remain positioned in Loan Balance and Geography stories. Within the geography stories, which are focused on New York collateral, our investments are

predominantly in the 4% and 4.5% coupons, while our loan balances exposures are more evenly distributed in 3% through 4.5% coupons.

Figure 2 shows the quarterly total return performance, by coupon, on TBA contracts, shown by the gray bars, and on our specified pool holdings, shown by the blue bars. The most notable properties of this chart are first, the higher the coupon the worse the quarterly performance and, second, only the 2.5% coupon assets were spared from material underperformance, which was clearly the result of Fed and bank support of the coupon.

Finally, Figure 3 shows a comparison, by coupon, of observed prepayment speeds from pools delivered into TBA contracts, again shown by gray bars, to observed prepayment speeds on our specified portfolio, again shown by blue bars. Overall, prepayment speeds in our specified pools remain significantly slower than pools delivered into TBA, showing the value of the prepayment characteristics of that collateral.

We also show a comparison of this quarter's prepayment rates to last quarter's, which you can see by looking at the diamonds above each bar. Here, you can clearly see the impact that the first quarter's rising rates had on prepayment speeds for at-the-money current coupon mortgages, as speeds on 2.5% coupon TBA slowed from 20 CPR to about 8 CPR. However, it is also evident from this chart that prepayment speeds on the higher coupons, both in TBA as well as in specified pools, have not materially declined despite the sharply higher interest rates in the first quarter. Whatever the reason for this persistence of fast prepayments in the high coupon sector, whether due to the introduction of the new government programs that I mentioned earlier, or due to something else, the market seems to have adjusted its forward-looking expectations for prepayment rates and extrapolated continued fast speeds far into the future, which was surely at least one of the causes behind the performance seen in Figure 2.

While there is no doubt that high coupon speeds have been fast, we do not believe that longstanding behaviors of mortgage borrowers have suddenly changed, and we do expect burnout to manifest itself in the high coupons at some point. Indeed, in the most recent prepay reports, we have started to see early signs of burnout as high coupon speeds slowed more than daycount. Already, some market participants are beginning to wonder whether the adjusted expectations have gone too far, and have reduced their forecasts on high coupons somewhat.

Despite the underperformance of the high coupon sector, we are still comfortable with our exposure especially given the widening experience this quarter. High coupon specified pools have a long history of being attractive, providing stable prepayment profiles along with generally wider spreads, which has made them good assets from which to extract high risk adjusted returns, and we do not see any reason to change that view.

Moving to slide 11, you can see in Figure 1 that our MSR portfolio was valued at \$2.0 billion as of June 30th, based on almost \$191 billion UPB and with a gross coupon of 3.5%. That translates into a price of about 106 cents or right around a 4.0 multiple given the modest amount of excess above the base servicing fee. The percentage of MSR in forbearance continued to decline throughout the quarter ending at 2.2% by loan count.

We settled on \$16.4 billion UPB of MSR through our flow program during the quarter and \$6.5 billion in bulk purchases, which together was more than enough to offset runoff in the period and grow the UPB by \$3.6 billion.

In Figure 2, we show our settled UPB for the flow and bulk channels for the last four quarters. As expected, the flow channel settlements have declined since the fourth quarter in parallel with the lower refinancing activity. Bulk settlements are more opportunistic in nature and therefore less predictable. Nevertheless, we have committed to purchasing \$25 billion UPB through the bulk channel year to date.

For reasons we have discussed previously, we expect the bulk volumes in the second half of the year to also be robust. Despite the recent retracement in interest rates during the second quarter, MSR values have appreciated meaningfully since 2020 and we expect that small- to medium-sized servicers will be incentivized to reduce mark-to-market volatility in their balance sheets and monetize their holdings. So while it is difficult to predict our activity and success in the bulk market, we are confident that market dynamics will be favorable and allow us to continue to grow our portfolio.

In Figure 3, we compare our servicing prepayment speeds in blue bars versus TBA collateral in grey bars. This is a similar chart to the chart on the previous page and shows that our MSR prepayment speeds are slower than TBA because of its collateral characteristics.

Moving to the charts on the top of slide 12, we show the combined exposures of Agency P&I bonds, MSR and IO as of June 30th as compared to our positioning at the end of the first quarter as indicated by the black diamonds.

Given the performance this quarter, I think some additional words about this page are in order to help describe our portfolio. Figure 1(a) in the top left shows the bond-equivalent value of our securities and TBA positions, and you can see that we have holdings in bonds ranging from 2.5% through 5% coupons which, in very round numbers, are equally distributed.

We have discussed many times about the characteristics of MSR, but let's quickly review. MSR, being an interest-only instrument whose value rises when rates rise and falls when rates fall, has negative interest rate duration, which offsets the exposure of RMBS securities. Furthermore, when primary mortgage rates rise, future prepayments are expected to slow, which makes interest-only instruments more valuable, and so MSR prices rise in that case too. In contrast,

in that scenario, the prices of current coupon RMBS securities will fall, since prices and yields move inversely to each other.

This behavior – MSR values rising when rates rise and when current coupon spreads widen - looks, smells, and acts like a short position in current coupon RMBS securities, and it is useful to think of MSR in this way. Figure 1(b) shows the duration and spread-risk equivalent of our MSR expressed in current coupon short positions. Comparing the gray bars to the black diamonds, the effective short position of the MSR asset shifted down in coupon and is now represented by a combination of 2.0% and 2.5% exposures. Figure 1(c) shows the two charts on the left added together, and represents our combined position.

As regular listeners know, we often speak about how our portfolio to mortgage spreads is low, and that is shown in Figure 2, where we indicate that our portfolio could be expected to lose 1.1% in a 25 basis point spread widening. But the important thing to remember is that that reflects a 25 bps point widening across the coupon stack including the current coupon spreads, where the MSR offset, the effective short position, is manifest. The MSR does not provide any spread hedge benefit if only non-current coupons experience material spread widening, as happened during this quarter.

On net, we are pretty the flat current coupon complex, as defined by the sum of 2% and 2.5% exposures, with a bias for 2.5's over 2's, and long the rest of the stack.

Moving to slide 13, here we see our interest rate and curve exposures. Both are low and in line with our historical positioning. I would call out again that the Agency + MSR strategy provides significant interest rate offsets, which you can see by comparing the dark grey bars to the blue bars in both Figure 1 and Figure 2. Given the rate rally during the second quarter, and the continued 25 basis point rally into July, you may be looking at the left hand side of these charts for the first time in quite a while. Although the end of quarter positions indicated that we would lose 1.8% in book value for an instantaneous 25 basis point parallel shift downward in rates, and 2.2% for a bull flattening of 25 basis points, it is important to note that these numbers reflect a snapshot in time, and we can, and do, actively hedge our portfolio as market conditions change. In particular, although we think that a less than 2% move for an instantaneous 25 basis point change in rates is not very big, very early in the quarter we reduced this exposure even further.

Finally, I'd like to discuss our outlook for Two Harbors and our return expectations for new investments on slide 14. This quarter, we split out the expected returns for investments in current coupons and high coupon assets as we see significantly different return profiles for the two. We also added some shading to show last quarter's returns.

Even with the market's faster prepayment expectations, we now see the long-term return potential of higher coupons hedged with swaps to be in line with

our investment goals in the high-single to low-double digits, which is a significant increase from the mid-single digit returns that we saw on these securities last quarter. And as I mentioned earlier, we feel that there is potential further upside to these returns in the case that burnout becomes manifest, current coupon spreads widen as the Fed and banks retreat over time, or any other reason that prepayment speeds and expectations moderate.

Current coupon specified pools hedged with swaps, however, still do not offer enough return and pose significant widening risk as a standalone investments. With TBAs still rolling special, near term returns can remain reasonably attractive in the absence of spread widening, with expected returns in the high-single to low-double digits. To be clear, the higher end of that range assumes roll specialness lasts forever, and the lower end of that range assumes a quick reversion to normal implied funding levels and relies on today's historically tight spread levels for its return.

When MSR is paired with specified pools, the combined expected return ranges from mid-single digits to mid-teens, depending on whether current coupon specified pools or high coupon specified pools are used in the paired construction and depending on a range of expected returns of MSR.

Finally, when current coupon TBA is paired with MSR, the range of expected returns is narrower than for MSR hedged with pools, and again depends on how long roll specialness lasts, as well as the range of expected returns of MSR. And as long TBAs is expressed in current coupon, then the exposure to spread risk will be very low.

We are excited about our investment opportunities in the paired Agency + MSR construction and we are focused on deploying capital there. As I mentioned previously, we expect there to be attractive opportunities to deploy more capital in both MSR and RMBS in the second half of the year. MSR supply should be ample as market participants look to monetize their MSR holdings, and we have a platform in place to acquire, service, and oversee significant new purchases. RMBS spreads are tight, still, but they won't be this tight forever. With the Fed talking about tapering, and the banks already beginning to at least moderate their purchases, we expect spreads to widen -- maybe gradually, maybe sharply -- but we are ready and able to participate in any such attractive investing opportunities when that occurs.

Thank you very much for joining us today, and we will now be happy to take any questions you might have.

QUESTION & ANSWER

- Operator And at this time, we will be conducting a question-and-answer session. If you would like to ask a question, please press “*”, “1” on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press “*”, “2” if you would like to remove your question from the queue.
- For participants using speaker equipment, it may be necessary to pick up your handset, before pressing the star keys. One moment, please, while we pull for questions.
- Our first question is from Doug Harter with Credit Suisse. Please proceed with your question.
- Doug Harter Thanks. Bill, just I was wondering if you could just talk about your thoughts around longer-term portfolio construction and kind of whether a quarter--two quarters like you just saw where you had significant divergence in coupon performance kind of makes you rethink about kind of how you would want to structure that coupon distribution with MSR and pools and whether you would want more of a balance, there?
- Bill Greenberg Sure. Good morning, Doug. Thanks very much for the question. So, as we show on Slide 12, the amount of MSR that we currently hold hedges a certain amount of mortgages--of current coupon mortgages, right.
- And so, as you see from the chart and as we said in the prepared remarks, we’re generally net flat, the current coupons, if you look at 2s and 2.5s and we have some relative value thoughts around liking 2.5s more than 2s there, which is why you see that positioning. And then we have more capital. And so we have to deploy that somewhere, right.
- And we have chosen to deploy that in the higher coupon specified pools. For reasons we discussed, as I said in my prepared remarks, the high coupon specifieds have a long history of, generally, having wider spreads and be having stable prepayment profiles, which makes it easier to extract spreads from those investments.
- Now, if I understand your question, you are wondering, well, maybe we should have that amount of capital deployed instead to lower coupons. And of course, we thought about that during the quarter, or before and we chose not to do that, mostly because we felt that there was significant widening risk from the Fed tapering in the low coupons.
- Now, it’s true, right. All spreads were tight in the quarter. And I guess we say, what we were surprised by, we were surprised that high coupons widens without low coupons widening, right.

If everything had widened in parallel, the performance would have been different. And so, going forward, we think that it is much more likely for the low coupons to widen without, necessarily, the high coupons sharing in that, going forward. That--certainly more likely than it is than the high coupons continue to widen, and the low coupons do nothing.

So, we like our positioning, here. And we think the high coupons offer a fair amount of value.

Doug Harter

Great. Thank you for that color, Bill.

Operator

And our next question is from Bose George with B. Riley FBR. Please proceed with your question.

Bose George

Hey, this is Bose, actually, from KBW. Actually, first, in terms of the capital that you guys raised, can you talk about just the deployment? Is that sort of the timeline for that, or is that going to be based on spread widening and what you see out there?

Bill Greenberg

Yeah, good morning, Bose. Thanks for the question. It's going to be a combination. We have been deploying some of that capital into our target assets, already, in terms of MSR and low coupon TBAs.

We've not deployed it all, as we have discussed previously, and in the prepared remarks. We expect better opportunities to invest in RMBS in the near-term. And in the paired construction, that's still attractive. So, we are deploying our capital there where we can.

Bose George

Okay, great. Thanks. And then, actually, in terms of the MSR as a percentage of the portfolio, can you just remind us, is there just kind of a level where it could go to, as you keep deploying capital there?

Bill Greenberg

Yeah, we don't have a set limit in mind. We manage the portfolio to a set of risks, both drawdown risk, and spread movement risk, as well as liquidity risks, and so forth. So, we don't have a firm number in mind, but we feel that we can grow that portfolio, substantially, in the near-term, if opportunity presents itself.

Bose George

Okay, great. Thanks. Just one more quick one. Can you give us an update on book value quarter-to-date?

Bill Greenberg

Yeah, sure. Book value is up, slightly, this quarter, so far, through the end of July. We were up around a 0.5%.

Bose George

Okay, great. Thanks.

Operator

And our next question is from Rick Shane with JPMorgan. Please proceed with your question.

- Rick Shane
- Hey, guys. Thanks for taking my questions, this morning. Most have been asked and answered. But I do want to talk about what we're seeing in the primary markets and how you think the competitive dynamics there are impacting prepayments. You've talked about some expectation of burnout on the higher coupon pools.
- But given the intense competition for volume and the fights over spread by the originators, why won't that persist as long as rates remain low, and the refi activity opportunity remains attractive?
- Bill Greenberg
- Yeah, good morning, Rick. Thanks for the question. Well, so, that's a long question and there's lots of moving pieces there, as you know. Certainly, I think in the lower coupons and the at the money coupons, speeds are expected to be fast.
- And obviously, depending on interest rates, and if rates were to push lower still, I think we would expect to see speeds there pick up.
- One thing that's interesting, though, is what people call the re-striking of the mortgage universe, right, which is that you have mortgage rates here to the borrowers I say, $2\frac{3}{4}$, $2\frac{7}{8}$, something like that.
- I read one thing, this week that said that the percentage of mortgage borrowers who have a 25-basis point incentive fee is right now around 61% of agency borrowers. The last time rates were here in January, with that same mortgage rate, 74% of borrowers were--had 25 basis points or more of incentive in the money.
- And so, that's just reflective of the fact that lots of people have refinanced already, right. And there's fewer people that have incentive at this rate level. And so, in order to get the same refinancing response, rates actually have to push a little bit lower.
- In terms of higher coupons, and so forth, look, the concept of burnout has been true for generations of mortgage borrowers and investors.
- And simply reflects the fact that after investors, after borrowers have had many opportunities to refinance at lower rates, the people who remain, who haven't, are less likely to do so when they see it's for the third time or the fourth time or the fifth time, alright.
- And despite the competition, and despite government programs, just people are less reactive, there. And we expect that to remain sure, at some point. And as I said, we're starting to see that in the July release of prepayments. We're seeing it in our own servicing portfolio, where we're able to track daily prepayments.

There's, obviously, a prepayment report released tonight. And Black Knight data has--is projecting that those prepayment speeds on high coupons will decline more than daycount, again. And so I think that's just a behavior of the way mortgage borrowers are.

Rick Shane Got it. Okay and very helpful. Thank you, Bill.

Bill Greenberg You're welcome.

Operator And our next question is from Kenneth Lee with RBC Capital Markets. Please proceed with your question.

Kenneth Lee Hi. Thanks for taking my question. Wondering if you could just share with us your current expectations for how long dollar roll specialness could be expected to last? Thanks.

Bill Greenberg Thanks Ken. Good morning. Thanks for being with us. I think that dollar roll specialness is intimately tied to the Fed and the bank buying. So, I think that that once you see those things moderate or start to retreat, I think you'll see roll specialness start to come off, as well.

Kenneth Lee Got it. Very helpful. And then just one follow-up, if I may. Just broadly speaking in terms of your hedging profile or positioning, is there anything special that's being done ahead of the potential Fed tapering, income scenarios being hedged, specifically, banks?

Bill Greenberg Yeah, well, we think that tapering or reduced buying does not have to be coincident with the change in interest rates. And so, there's not much rate hedging or portfolio hedging to do but our very positioning of being short 2s and generally flat the current coupon complex is, by its construction, a hedge, a portfolio hedge to that tapering process. And so, when I think about what the risks in the portfolio are, one of the things that's not a risk for our portfolio is Fed tapering.

Kenneth Lee Got it. Very helpful. Thanks again.

Bill Greenberg Thank you.

Operator And our next question is from Trevor Cranston with JMP Securities. Please proceed with your question.

Trevor Cranston Alright, thanks. Good morning. A follow-up on the question about your positioning within the coupon stack and being sort of neutral 2s and 2.5s and continuing to be along the high coupons. I was curious when you think about the risks to the portfolio and that positioning, what kind of scenarios could you foresee that would actually cause high coupons to continue underperforming, after what we've already seen in the second quarter?

Would that be sort of related to policy risks around making refis easier or are there other trends that you can foresee causing high coupons to continue to underperform? Thanks.

Bill Greenberg

Yeah, thanks for that question. Yeah, it would be something like that. I mean, many people have talked, this quarter, about whether the underperformance in high coupons has been a constant spread event and only changing prepayment expectations or not a change in expectations and only a spread widening event.

We sort of come down in the middle of that. And we think that that, even with increased prepayment expectations in those high coupons, that these expected returns on those assets are attractive and consistent with our goals, as we show on page 14, right.

And so, we think that, that you would have to see prepayment expectations increase even from here, which I think has been done quite a lot. And so, I view that as unlikely. And all of these government programs and increased policy risk has generally been incorporated into the prices, already. So, it's hard for me to see how that would happen more and again.

I think there's a bigger risk to prices and spreads in the lower coupons. And so as I said, as you said, that we were surprised by something, it was that the high coupons widened, and lower coupons didn't. But that happened, differentially.

And now, I think the risk is inverted to the other way. And I think high coupons look more attractive than low coupons for the opposite reason.

Trevor Cranston

Okay, that makes sense. And I was curious, when we listen to some of the earnings calls from the originators, it sounds like a lot of them are focusing much more intently on trying to increase cash out refi.

So, I was curious, do you think increased focus there could be significant enough to prevent burnout and slowdown or is that something that's, likely, to be much more marginal and not that significant?

Bill Greenberg

Yeah, it could be, it's hard to know. I think mortgage originators always like cash out refis, because the balances are bigger, and if they make a point or whatever or two points on every loan, they like the bigger balances.

And so, we do live in a period where there's been a significant HPA, and it's not surprising that the originators want to do that.

So, I think that's part of the overall refinancing machine and is in people's prepayment expectations, already. I mean, it could be significant, but I think it's - I think it's in peoples' expectations.

- Trevor Cranston Okay, got it. And then last thing, apologies if you already addressed this, I got on to the call a little bit late. But the increase in the portfolio yield during the second quarter, could you just talk through what drove the jump there? Thanks.
- Bill Greenberg Yeah, I'll let Mary take that one, please.
- Mary Risky Sure. Good morning, Trevor. So, the increase in yield came, primarily, from an increase in MSR yields.
- Trevor Cranston Okay, got it.
- Mary Risky The bulk of it.
- Trevor Cranston Yeah, okay, that makes sense. Thank you.
- Operator And our next question is from Eric Hagen with BTIG. Please proceed with your question.
- Eric Hagen Hey. Thanks. Good morning. One follow-up on the \$17.5 billion in bulk since quarter end, was that a single package or was it multiple packages? And can you talk about how you expect to finance it, like how much of the excess capacity from your financing lines are being used to acquire those-that package or packages?
- Bill Greenberg Yeah, I'll let Mary take that one, too.
- Mary Risky Yeah, it's multiple packages. And then, I'm sorry, the second part of your question was relating to financing.
- Eric Hagen Yeah, how much of the excess capacity from your financing lines is being used to acquire those packages?
- Mary Risky Well, I would just say that we will continue to increase the usage of MSR financing, going forward, as the portfolio grows. We have plenty of capacity on our facilities. And we'll use that to optimize the financing on that asset.
- Eric Hagen Okay. I guess what I'm getting at is like, what is the pro forma leverage? I mean, that's a big package of bulk. What is the pro forma leverage for taking that onto your balance sheet, considering the equity raise in July, as well?
- Mary Risky Well, we typically--the advance rates on MSR is around 70%. And we will--we will optimize usage of the facilities given the use requirements and that compared with our excess cash on hand to determine the right amount of drawdown on those facilities.
- Eric Hagen Okay. Alright, thank you.

Operator And we have reached the end of the question-and-answer session. And I will now turn the call over to William Greenberg for closing remarks.

Bill Greenberg Thank you very much for everyone for joining us, today. And thank you, as always, for your interest in Two Harbors. Have a good day.

Operator This concludes today’s conference, and you may disconnect your lines, at this time. Thank you for your participation.

Bill: Thank you once again for joining us today, and thank you for your interest in Two Harbors

CONTACT INFORMATION

Investor Relations
Two Harbors Investment Corp.
612-446-5431
investors@twoharborsinvestment.com